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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	CC Docket No. 93-251

COMMENTS OF
AMERICAN TELEPHONE AND TELEGRAPH COMPANY

Francine J. Berry
Robert J. McKee
Judy Sello

Room 3244J1
295 North Maple Avenue
Basking Ridge, NJ 07920

Marc E. Manly
Ashutosh A. Bhagwat

1722 Eye Street, N.W.
Washington, D.C. 20006

Its Attorneys

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SUMMARY

The NPRM proposes a broad revision of the Commission's affiliate transactions rules in order to enhance the Commission's "ability to keep carriers from imposing the costs of nonregulated activities on interstate ratepayers, and to keep ratepayers from being harmed by carrier imprudence." The revisions proposed in the NPRM, as well as the existing rules, are designed to prevent regulated carriers from manipulating affiliate transfer prices as justification for higher regulated rates.

The NPRM (at ¶ 101), however, properly notes that these rules may no longer be necessary with respect to AT&T. The competitive interexchange market does not permit any inflating of AT&T's interexchange prices by improper transfer pricing. As the Commission explains, "AT&T has often elected to set prices at levels below the price cap maximums" and such "below cap pricing suggests competitive pressures on the rates AT&T can charge and limits on its ability to increase prices as a result of cost shifting." Effective competition exists for all of AT&T's services, and most certainly with respect to those services for which the Commission has removed price cap controls. And as to those streamlined services, AT&T has absolutely no incentive to manipulate its transfer prices -- AT&T currently has full discretion to establish prices without regard to affiliate transfers.

The Commission need not reach the question, however, of whether all of AT&T's services are subject to effective competition in order to conclude that its affiliate transactions

rules as applied to AT&T have outlived their usefulness. The NPRM acknowledges that "[s]ince the adoption of the affiliate transactions rules, we have adopted a price cap system for AT&T that imposes no sharing obligation," and that this system of AT&T price regulation "greatly reduces the incentives that AT&T may have to shift costs between its nonregulated operations and its carrier operations . . . [because] attempts by AT&T to manipulate the costs it records for affiliate transactions will not increase AT&T's rates."

Under its price cap system, AT&T's endogenous costs (the costs of capital, labor, materials, and services obtained from any source, including affiliates) have no impact whatsoever on the rates AT&T can charge. The price caps were initially based on historical costs, and only changes in AT&T's exogenous costs lead to adjustments in the price cap levels. Therefore, no change in affiliate transfer prices can impact the prices AT&T may charge for the services still subject to price cap regulation. Nor does AT&T have any incentive to manipulate its affiliate transfer prices in order to evade any "sharing" obligation that could otherwise affect its rates. The NPRM expressly recognizes this fact in noting that AT&T's price cap system "imposes no sharing obligation."

Accordingly, the underlying premise of the affiliate transactions rules is entirely inapplicable to AT&T's interexchange activities and there is no legitimate regulatory interest served or benefit provided by their continued application. In contrast, the continuation of those rules

imposes substantial direct and indirect costs: the public and private resources that must be expended to comply and to audit that compliance; the foregone efficiencies of self-supply that may be discouraged (particularly under the proposed revisions); and the distorting effects of subjecting only one interexchange competitor to these requirements. As a matter of basic cost/benefit analysis, the unnecessary regulatory burden of the affiliate transactions rules should be eliminated from AT&T. That result will be fully consistent with the Commission's actions in numerous other proceedings in which outmoded regulations have been removed or streamlined in recognition of the marketplace and regulatory realities that now prevail for interexchange services.

If the Commission nevertheless decides that some continuing oversight of AT&T's affiliate transactions is necessary for some remaining transition period, it should apply the existing rules rather than impose the proposed new rules. This would avoid the wholly unwarranted expense to AT&T of transforming its accounting systems.

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COMMENTS OF
AMERICAN TELEPHONE AND TELEGRAPH COMPANY

Pursuant to Section 1.415 of the Commission's Rules, 47 C.F.R. § 1.415, American Telephone and Telegraph Company ("AT&T") submits these comments on the Commission's Notice of Proposed Rulemaking concerning new accounting rules with respect to transactions between carriers and their nonregulated affiliates.[1] In particular, AT&T responds to the Commission's request for comments regarding whether, in light of the competitive interexchange market, together with the specific price regulation applicable to AT&T, these rules should be applied to AT&T. NPRM, ¶ 101.

PRELIMINARY STATEMENT

As a part of its regulation of common carriers, the Commission has promulgated rules governing the manner in which carriers must record their costs and revenues under the Uniform

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[1] Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates, CC Docket No. 93-251, Notice of Proposed Rulemaking, FCC 93-453, released October 20, 1993 (hereinafter "NPRM").

System of Accounts ("USOA").[2] These rules currently apply to all non-average schedule local exchange carriers ("LECs"), but to only two interexchange carriers, AT&T and Alascom, and even Alascom is exempt from substantial portions of the rules.[3] As part of these requirements, the Commission's affiliate transactions rules specifically address the accounting treatment of transactions between regulated carriers and their nonregulated affiliates.[4]

The NPRM proposes a broad revision of the affiliate transactions rules, and of certain related rules, including those governing preparation by carriers of Cost Allocation Manuals ("CAMs") and annual independent audits. Specifically, the proposals would (1) prohibit carriers from valuing affiliate transactions at a "prevailing company price" unless 75 percent of the nonregulated affiliate's output was sold to non-affiliates (NPRM, ¶¶ 82-85); (2) require carriers to trace the costs associated with certain affiliate transactions through a "chain" of transfers within an affiliate group, tracking the value-added at each stage (id., ¶¶ 48-50); (3) require carriers to maintain a complete set of regulatory books for all nonregulated affiliates who engage in transactions with carriers (id., ¶¶ 41, 57-76); and

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[2] 47 C.F.R. Part 32.

[3] NPRM, ¶¶ 7, 100 & n.95.

[4] See 47 C.F.R. § 32.27; Separation of Costs of Regulated Telephone Services from Costs of Nonregulated Activities, Report and Order, CC Docket No. 86-111, 2 FCC Rcd. 1298, recon., 2 FCC Rcd. 6283 (1987), further recon., 3 FCC Rcd. 6701 (1988), aff'd sub nom. Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

(4) require carriers to estimate, monitor, and true-up on a quarterly basis affiliate transactions costs (id., ¶¶ 77-81).

The stated purpose of these proposals is to "enhance [the Commission's] ability to keep carriers from imposing the costs of nonregulated activities on interstate ratepayers, and to keep ratepayers from being harmed by carrier imprudence." NPRM, ¶ 1. That is, the affiliate transactions rules are intended to prevent regulated carriers from "cross-subsidizing" nonregulated activities from their regulated, monopoly services by shifting costs from the former operations and activities into their regulatory revenue requirements, with the effect of higher tariffed rates and higher profits to the combined enterprise than would otherwise occur.

As to AT&T, however, the Commission properly acknowledges that its affiliate transactions rules may no longer be necessary because of the market circumstances that exist for interexchange services, and because of the specific regulatory price controls that apply to AT&T. First, the competitive interexchange marketplace does not permit any inflating of AT&T's regulated rates through manipulation of transfer prices between affiliates. The Commission notes that "AT&T has often elected to set prices at levels below the price cap maximums" and such "below cap pricing suggests competitive pressures on the rates AT&T can charge and limits on its ability to increase prices as a result of cost shifting." NPRM, ¶ 101.

In addition, the Commission explains that "[s]ince the adoption of the affiliate transactions rules, we have adopted a

price cap system for AT&T that imposes no sharing obligation."[5] This system of price regulation "greatly reduces the incentives that AT&T may have to shift costs between its nonregulated operations and its carrier operations . . . [because] attempts by AT&T to manipulate the costs it records for affiliate transactions will not increase AT&T's rates." Id. Accordingly, and "[i]n view of these reduced incentives to shift costs," the Commission seeks comments on whether AT&T should be subject to the proposed revisions to the Commission's affiliate transactions rules.

I. THERE IS NO LONGER ANY BASIS FOR SUBJECTING AT&T TO AFFILIATE TRANSACTIONS RULES.

The Commission's analysis concerning the lack of any current justification for applying affiliate transactions rules to AT&T is absolutely correct. As the Commission suggests, AT&T should not be "subject to . . . the system we propose for affiliate transactions."[6] Indeed, it is no longer necessary to apply even the existing rules to AT&T's operations. These conclusions are not only consistent with, but compelled by recent decisions that have eliminated or substantially reduced

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[5] NPRM, ¶ 101 & n.96, citing Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. 2873, 2893-98 (1989) ("AT&T Price Cap Order"), recon., 6 FCC Rcd. 665 (1991), remanded on other grounds sub nom. AT&T v. FCC, 974 F.2d 1351 (D.C. Cir. 1992). The Commission also notes that in its recent review of the AT&T price cap plan, it concluded that price cap regulation has worked well, and has produced substantial consumer benefits as well as enhancing interexchange competition. NPRM, ¶ 101 n.97, citing Price Cap Performance Review for AT&T, CC Docket No. 92-134, Report, 8 FCC Rcd. 5165 (1993).

[6] NPRM, ¶ 101. See also id., ¶¶ 65 n.65, 67 n.71, 76 n.78, 103.

inappropriate regulation of AT&T.[7] Precisely the same reasoning supports a decision in this proceeding to remove all affiliate transactions rules and reporting requirements as to AT&T.

A. Given The Competitive Interexchange Market, AT&T Has Neither The Ability Nor The Incentive To Attempt To Shift Costs Or To Raise Its Rates For Regulated Services Above Competitive Levels.

As the NPRM (¶ 101) notes, and as the Commission has acknowledged repeatedly, the interexchange marketplace is vigorously competitive. In the ten years following the divestiture of the Bell System, several hundred carriers have begun providing interexchange service in competition with AT&T.[8] At least twelve of these carriers provide service over their own fiber-optic facilities, and several carriers now operate national fiber networks.[9] Most notably, AT&T's two largest facilities-based competitors, MCI and Sprint, have both grown into multi-billion dollar enterprises providing ubiquitous national and international service, and competing with AT&T in every sector of the interexchange market. Furthermore, AT&T's competitors now

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[7] See Simplification of Depreciation Prescription Process, CC Docket No. 92-296, Report and Order, FCC 93-452, released October 20, 1993; Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Second Report and Order, 8 FCC Rcd. 3668 (1993) ("800 Streamlining Order"); AT&T Communications Elimination of Reporting Requirements, DA 92-1157, Order, 7 FCC Rcd. 5568 (1992); Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Report and Order, 6 FCC Rcd. 5880 (1991) ("IXC Rulemaking Order"); Computer III Remand Proceedings, CC Docket No. 90-368, Report and Order, 5 FCC Rcd. 7719, 7721 (1990).

[8] Trends in Telephone Service, FCC Industry Analysis Division, March 1993, p. 33, Table 20.

[9] Fiber Deployment Update, FCC Industry Analysis Division, p. 4, April 1993.

possess about one and a half times the number of route miles of fiber as the AT&T network,[10] and "have enough readily available supply capacity to constrain AT&T's market behavior and inhibit it from charging excessive rates."[11] As a consequence of this competitive explosion, every service that AT&T provides is now offered by at least two of its competitors and AT&T's share of interstate switched minutes has steadily declined over the past decade.[12]

The Commission itself has explained that interexchange "competition in business services is thriving," and that this competition "extends not only to large business customers, but also to smaller ones."[13] On this basis, the Commission has adopted streamlined regulation for most of AT&T's business services, including the elimination of price caps for those

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[10] Id.

[11] IXC Rulemaking Order, 6 FCC Rcd. at 5889. The Commission further agrees that available capacity is the best measure of competition in the interexchange market. Id.

[12] See AT&T Comments, Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, filed July 3, 1990, pp. 22-54; AT&T Comments, Price Cap Performance Review for AT&T, CC Docket No. 92-134, filed September 4, 1992, pp. 14-25; Long Distance Market Shares: Fourth Quarter, 1992, FCC Industry Analysis Division, March 1993; see generally Motion for Reclassification of AT&T as a Nondominant Carrier, Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, CC Docket No. 79-252, filed September 22, 1993 ("AT&T Reclassification Motion"); Michael E. Porter, "Competition in the Long Distance Telecommunications Market," Monitor Company, September 1993 (attached to AT&T Reclassification Motion). AT&T hereby incorporates by reference the AT&T Reclassification Motion and further pleadings in that proceeding as well as any pleadings incorporated by reference therein.

[13] IXC Rulemaking Order, 6 FCC Rcd. at 5892, 5900 (emphasis added).

services.[14] Similarly, earlier this year the Commission found that essentially all of AT&T's 800 services were "subject to substantial competition," and therefore adopted streamlined regulation for those services.[15] In yet other proceedings, the Commission has stated that there is "robust competition in the interexchange market" and a "dramatic increase in the growth and strength of competition in the interstate interexchange marketplace."[16]

Economic analysis confirms the Commission's views regarding the vigorous state of competition in the interexchange market. The attached Statement of Dr. John Haring and Dr. Jeffrey Rohlfs demonstrates that the interexchange market is entirely competitive.[17] In particular, Dr. Haring and Dr. Rohlfs

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[14] Id. at 5893-96.

[15] 800 Streamlining Order, 8 FCC Rcd. at 3669-70. Although the Commission has not yet streamlined regulation of AT&T's Basket 1 (residential, IMTS, and operator) services, there is no doubt that those services are also heavily competitive. See AT&T Reclassification Motion at 14-15 & n.45, citing AT&T Comments, Price Cap Performance Review for AT&T, CC Docket No. 92-135, filed September 4, 1992. Indeed, AT&T's largest competitor, MCI, has itself agreed that in light of interexchange competition, "there is no reason to continue price cap regulation of AT&T." Id. at 15 & n.45, quoting MCI Comments, Price Cap Performance Review for AT&T, CC Docket No. 92-135, filed September 4, 1992, pp. 7-8.

[16] See Tariff Filing Requirements for Interstate Common Carriers, CC Docket No. 92-13, Report and Order, 7 FCC Rcd. 8072, 8079 (1992), rev'd on other grounds sub nom. AT&T v. FCC, No. 92-1628 (D.C. Cir. June 4, 1993), cert. granted Nos. 93-356, 93-521 (November 29, 1993); Tariff Filing Requirements for Nondominant Common Carriers, 8 FCC Rcd. 6752, 6753-54 (1993), petns. for review pending Nos. 93-1562, 93-1568, 93-1590, 93-1624 (D.C. Cir.).

[17] "The Absence of a Public Policy Rationale for Applying Affiliate-Transaction Rules to AT&T," prepared by Dr. John Haring (continued...)

note that the presence of substantial numbers of competitive interexchange carriers, coupled with low entry barriers and the existence of substantial available capacity in the networks of AT&T's facilities-based competitors, are a complete and effective check on AT&T's ability unilaterally to raise prices. In short, Haring/Rohlfs (p. 4) conclude that " t]he long-distance market has become highly competitive . . . and] [p]rices are now primarily constrained by market forces."

Given the state of effective competition within the interexchange market, it is neither appropriate nor useful for the Commission to apply affiliate transactions rules to AT&T, just as it is not necessary to apply them to any of AT&T's interexchange competitors.[18] As noted in the NPRM (¶ 1), the proposed rules are designed to preclude a carrier from engaging in improper cost-shifting between regulated and nonregulated activities.[19] The incentive to engage in such behavior arises from a regulated carrier's presumed ability to recover the excess

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[17] (...continued)
and Dr. Jeffrey H. Rohlfs, December 10, 1993 (hereinafter cited as "Haring/Rohlfs").

[18] The only other interexchange carrier subject to any affiliate transactions rules is Alascom, which unlike all other interexchange carriers is also subject to traditional rate-of-return regulation. See NPRM, ¶ 100. Other interexchange carriers have affiliates with which they conduct business. See, e.g., The Williams Companies, Inc., 1992 Annual Report, p. 11; RochesterTel, 1992 Annual Report and Investor Supplement, pp. 18-19.

[19] The Commission's rules are specifically designed to prevent a regulated carrier from shifting costs from a nonregulated affiliate into its regulated revenue requirement, by either underpricing assets or services provided to the affiliate by the carrier, or overpaying for assets or services provided by the affiliate to the carrier. NPRM, ¶ 3.

costs shifted into its ratebase from consumers of its regulated, monopoly services -- that is, to evade effective regulatory controls which would otherwise limit a firm's regulated rates and profits. Absent this circumstance, there is simply no incentive whatsoever to engage in such cost-shifting.[20]

No such incentive or ability exists for AT&T in the interexchange market. As Haring/Rohlfs conclude, as a consequence of the competitive interexchange market, "AT&T cannot profitably raise prices above competitive levels -- no matter at what prices affiliate transactions take place." Haring/Rohlfs, p. 4 (emphasis added). And even if AT&T (inexplicably) did attempt such cost-shifting, consumers would suffer no harm because AT&T cannot profitably raise its prices to recover those shifted costs. Haring/Rohlfs, pp. 9-10.

The existence of effective competition in the interexchange market thus eliminates any legitimate concern that AT&T might increase its prices by shifting costs from

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[20] As a matter of fundamental economic theory, no firm (even one possessing market power) has an incentive to shift costs between separate productive activities because the profit-maximizing price and output are not affected by any change or manipulation of internal transfer prices. The pricing of internal transfers above or below market prices therefore produces no benefits to the firm nor disadvantage to any consumer or competitor. See, e.g., 4 Phillip Areeda and Donald Turner, Antitrust Law ¶ 1003a at 218 (1980) (the "postulated advantage of [cost shifting] is a phantom and the postulation a fantasy"); 3 Areeda and Turner, Antitrust Law ¶ 724b at 196-97 (1978); id., ¶ 725b at 199. See also Robert Bork, The Antitrust Paradox, p. 228 (1978). The only exception to this conclusion exists under rate-of-return regulation. Such regulation can create an incentive to inflate transfer prices from nonregulated affiliates, because shifted costs may be used to increase the regulatory revenue requirement, yielding higher regulated prices, and permitting a greater recovery of monopoly rents. See NPRM, ¶ 8.

nonregulated activities to regulated services (NPRM, ¶ 1), and permits the Commission to remove unnecessary regulation of AT&T's affiliate transactions. Such action would be fully consistent with the Commission's recent decision, for example, with respect to equivalent issues concerning depreciation accounting.[21] As to that matter, the Commission concluded that because of the competitive interexchange market, AT&T lacks the ability and incentive to engage in cost-shifting, and should therefore be subject to substantially reduced burdens in maintaining its regulatory depreciation accounts. The exact same logic compels the conclusion that affiliate transactions rules have outlived any useful applicability to AT&T.

B. The Price Regulation Applied To AT&T Creates No Possible Incentive To Shift Costs.

The competitive market circumstances for AT&T preclude the possibility of improper cost-shifting and inflated rates for interexchange service. Although these market circumstances alone justify the elimination of affiliate transactions rules for AT&T, a finding that all of AT&T's services are subject to effective competition is not a necessary prerequisite to such elimination. Whatever one may think about the scope of interexchange competition, the existing system of AT&T price controls provides no mechanism or incentive for improper affiliate transfer pricing.

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[21] Simplification of the Depreciation Prescription Process, Report and Order, supra, p.5 n.7, ¶¶ 89-94; see also id., ¶ 16 (AT&T "faces significant competition in the interexchange market"); id., ¶ 19.

First, virtually all of AT&T's business services have been removed from price cap controls and are therefore no longer subject to any price regulation.[22] With respect to these services, the notion of cost-shifting by improper affiliate transfer pricing is a non sequitur because there is no "ratebase" or revenue requirement into which costs could be shifted. Instead, AT&T can freely set its prices for those services without recourse to a revenue requirement showing.[23] As Haring/Rohlfs (p. 4) conclude:

> "[m]uch of AT&T's revenue is now derived from services subject to streamlined regulation. AT&T's pricing of streamlined services is not subject to direct regulatory constraints. Affiliate transactions, no matter at what price, do not affect what AT&T is allowed to charge for services subject to streamlined regulation."

Second, even with respect to AT&T's services still subject to price caps, the specifics of AT&T's price cap plan eliminate any ability or incentive to shift costs. AT&T's price caps were established on the basis of historical rates, and the caps are only adjusted for limited factors -- inflation (net of a fixed productivity offset), access charges, and other exogenous cost changes.[24] Most crucially, AT&T's endogenous costs, including the transfer prices of goods or services from

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[22] See IXC Rulemaking Order, 6 FCC Rcd. at 5893-96; 800 Streamlining Order, 8 FCC Rcd. 3668.

[23] The Commission removed price cap controls from these services precisely because it found that market forces, rather than regulatory price controls, were a more efficient and effective check on AT&T's pricing. See, e.g., IXC Rulemaking Order, 6 FCC Rcd. at 5890-900.

[24] 47 C.F.R. § 61.44.

nonregulated affiliates, have no effect whatsoever on AT&T's price caps or on the rates AT&T may charge. As the NPRM explains, "[s]ince AT&T's price caps are unrelated to AT&T's current costs, attempts by AT&T to manipulate the costs it records for affiliate transactions will not increase AT&T's rates."[25] See also Haring/Rohlfs, pp. 11-12.

Nor does AT&T have an incentive to manipulate transfer prices in order to evade any "sharing" obligation. Under the LEC price cap plan, rates-of-return above a threshold level require a reduction in regulated prices, so that consumers will "share" in the higher profits of the carrier. This provides incentives to understate computed returns that might otherwise trigger "sharing" by, among other devices, overstating the costs or value of items provided by nonregulated affiliates.[26] But as the Commission expressly notes in the NPRM, AT&T's price cap system "imposes no sharing obligations." NPRM, ¶ 101. Furthermore, "[i]n contrast to the AT&T price cap system, . . . [the one] adopted for LECs imposes extensive sharing obligations." NPRM, ¶ 103. For this reason, the Commission describes the purpose of its affiliate transactions rules as one "to assist [the Commission] in determining the LECs' sharing obligations."[27] See also Haring/Rohlfs, p. 11.

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[25] NPRM, ¶ 101, citing AT&T Price Cap Order at 2893-98.

[26] Or equivalently, by understating the costs or value of items provided to nonregulated affiliates by the carrier.

[27] NPRM, ¶ 103 (emphasis added); see id., ¶ 10 n.14.

The Commission has acknowledged that AT&T's regulatory circumstances, including the absence of a sharing obligation in its price cap rules, eliminate any basis for burdensome regulation of AT&T's accounting practices, and has therefore removed unnecessary requirements.[28] Most notably, the Commission recently adopted a revised depreciation prescription process for AT&T on these grounds:

> "[W]e conclude that AT&T should be allowed to use [a simplified form of depreciation accounting]. Our reservations about adopting this option for the LECs do not extend to AT&T. AT&T's price cap plan does not include a sharing component. Thus, AT&T will not have an incentive to manage earnings to avoid sharing them with ratepayers. Furthermore, AT&T faces a more competitive market than LECs."[29]

In short, the basic assumption of the cost-shifting/cross-subsidization theory (i.e., that a regulated carrier can recover inflated transfer prices or other shifted costs through higher regulated price levels) is entirely inapplicable to AT&T, obviously with regard to AT&T services no longer subject to any direct price regulation, but also for services subject to AT&T's price cap regulatory system.

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[28] See Simplification of Depreciation Prescription Process, Report and Order, supra, p. 5 n.7; AT&T Communications Elimination of Reporting Requirements, DA 92-1157, Order, 7 FCC Rcd. 5568 (1992); see also Computer III Remand Proceedings, Report and Order, 5 FCC Rcd. at 7721 & n.49.

[29] Simplification of Depreciation Prescription Process, Report and Order, supra, p.5 n.7, ¶ 92. See also id., ¶¶ 15 n.17, 4 n.8, 19, 42. See also NPRM, ¶¶ 10 n.14, 103.

C. Continued Application of Affiliate Transactions Rules To AT&T Would Impose Substantial Costs Without Providing Any Offsetting Benefits.

As Drs. Haring and Rohlfs discuss, in determining whether to apply its existing or new affiliate transactions rules to AT&T, the Commission should conduct a cost/benefit analysis of its actions. Haring/Rohlfs, pp. 3-5 And the result of this analysis is apparent: continuing to subject AT&T to the affiliate transactions rules would provide no benefits, but would impose substantial costs on AT&T, the Commission, and the public at large.

As demonstrated above, it is clear that continued application of affiliate transactions rules to AT&T provides no regulatory benefits. Drs. Haring and Rohlfs, for example, conclude that:

> "AT&T plainly operates in a highly competitive environment. Any attempt by AT&T to raise prices would simply afford its rivals an opportunity for expansion -- an opportunity they have repeatedly proven themselves capable of exploiting in short order. Given this first line of defense, there is little good that application of affiliate-transaction rules to AT&T can accomplish. Residual regulation of AT&T is a combination of streamlined regulation and pure price caps with no provision for sharing earnings. Such regulation provides an important second line of defense; namely, affiliate transactions at inappropriate prices cannot increase the prices that AT&T is allowed to charge. Hence, application of the rules to AT&T is unlikely to provide any public benefits."[30]

In contrast to non-existent benefits, continued application of affiliate transactions rules would generate substantial costs. First, the rules would clearly impose

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[30] Haring/Rohlfs, pp. 14-15.

significant direct costs on both the Commission and AT&T. In particular, the Commission will be required to expend substantial (and scarce) regulatory resources monitoring AT&T's accounting reports, including both its accounting manual and its implementation of that manual. See Haring/Rohlfs, p. 13. AT&T must also devote resources to the matter. Just the existing rules require substantial effort and expense to ensure compliance. Worse still, the proposed rules would require AT&T to develop and maintain new administrative systems to track affiliate transactions. As Haring and Rohlfs discuss, such systems "have little value to the firm, apart from regulatory compliance. . . . Consequently, virtually the entire cost of [such a system] is a burden of regulation. Such compliance costs, and related costs such as those of an independent audit, are likely to be very substantial." Id., p. 12. Moreover, many of the Commission's specific proposals are thoroughly impractical, either because they are virtually impossible to implement as currently proposed, or because the costs of creating the systems necessary to implement the rules would be staggering. See Part II, infra.

Second, there are substantial indirect costs associated with subjecting AT&T to the rules. At the most basic level, the new rules could discourage self-supply, even when such transactions create significant efficiencies. The consequences of this bias "would be higher costs, lower productivity and a loss of competitiveness." Haring/Rohlfs, p. 14. In addition, the continued imposition of these rules on AT&T would distort

interexchange competition, because only one competing interexchange carrier, AT&T, would be subject to them. It is simply untenable that AT&T, alone among its competitors, be burdened by regulatory rules that provide no benefit, impose unnecessary costs, and discourage the achievement of efficiencies that ultimately redound to all consumers of interexchange service.

The existence of these substantial harms, combined with the complete absence of any offsetting benefits, counsels strongly in favor of the Commission adopting the suggestion in paragraph 101 of the NPRM, and excluding AT&T from its affiliate transactions requirements. The ultimate conclusion of Drs. Haring and Rohlfs is exactly on point:

> "the Commission has positioned itself to take advantage of an excellent opportunity to further rationalize its regulation of the long-distance marketplace in the public interest. By relieving AT&T of the need to comply with these rules, the Commission can conform its regulation better to today's marketplace (not to mention regulatory) realities and free-up valuable resources to address real problems of pressing concern."[31]

II. IN THE EVENT THE COMMISSION CONCLUDES THAT SOME OVERSIGHT OF AT&T'S AFFILIATE TRANSACTIONS IS NECESSARY, ONLY THE EXISTING RULES SHOULD APPLY.

If the Commission nevertheless decides that some continuing review of AT&T's affiliate transactions is necessary, at most it should apply the existing rules. This would be consistent with the Commission's express policy of recognizing the competitive context in which AT&T operates, and removing

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[31] Haring/Rohlfs, p. 15 (footnote omitted).

obsolete rules and streamlining others in order to permit more efficient market forces, rather than cumbersome regulatory intrusion, to control behavior and determine outcomes.[32]

The use of the existing rules in those circumstances would avoid the totally unnecessary costs of transforming AT&T's accounting systems to comply with the proposed new rules. In this regard, AT&T is particularly concerned with several specific aspects of the proposed new rules, compliance with which would be extremely burdensome, if not impossible.

For one, the Commission proposes that when affiliate transactions involve resources that have already been transferred within an affiliate group, the carrier be required to apply the rules to each transfer, or "link," within the chain of transfers, and calculate the value-added at each stage.[33] This approach is simply unworkable as applied to many affiliate transactions. For example, it is often the case that the final, transferred product in an affiliate transaction is a sophisticated device, such as a switch, having a large number of component parts. These parts were in all likelihood themselves transferred among affiliates prior to incorporation into the final product. The Commission's proposed rules would require AT&T to trace every nut and bolt incorporated into the switch, through a chain of transfers, to derive a cost basis for the final product and for every intermediate product. The expense of such an undertaking would obviously be staggering.

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[32] See, e.g., p. 5 n.7, supra (citing Commission decisions).

[33] NPRM, ¶¶ 48-50.

Similarly, the Commission proposes that the costs of affiliate transactions be estimated on an on-going basis, with a monitoring and true-up every quarter.[34] Again, AT&T does not believe it has the capacity to provide accurate, on-going cost estimates as the Commission proposes to require, and furthermore believes that the costs of truing-up its books on a quarterly basis would far exceed any value to be gained from such a procedure.

Finally, the Commission proposes to limit use of a "prevailing company price" to affiliates who sell at least 75 percent of their output to non-affiliates. NPRM, ¶¶ 82-85. As Drs. Haring and Rohlfs discuss, however, a 75 percent threshold is far higher than any economic principles or theory would justify:

> "A market price is established if any significant group of market participants engages in arm's length transactions at that price. In particular, suppose that a significant group of customers buys a good or service at a certain price from an unregulated affiliate of AT&T. These transactions provide evidence that AT&T's regulated operations would have to pay at least that same price if they relied on external supply. Indeed, the next best source of supply, other than AT&T, may be at a higher price."[35]

The Commission's approach is thus entirely over-restrictive for AT&T, and would substantially increase AT&T's accounting costs.[36]

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[34] Id., ¶¶ 77-81.

[35] Haring/Rohlfs, p. 13 (emphasis in original).

[36] See Haring/Rohlfs, p. 13 ("[d]ue to AT&T's vertically-integrated structure and its use of customized products and services, an AT&T affiliate would often be unable to meet the threshold of 75 percent third-party sales, even when it is a major supplier to an established third-party market for those goods and services").

Moreover, it would establish a bias against efficient self-supply, with consequent "higher costs, lower productivity and a loss of competitiveness." Haring/Rohlfs, p. 14.

For these and other reasons, the incremental cost to AT&T of converting its internal accounting systems to comply with certain aspects of the Commission's proposed new affiliate transactions rules would be substantial. The costs of such revisions would of course be in addition to the costs that AT&T already (and alone among its interexchange competitors) bears in complying with the Commission's existing affiliate transactions rules. Therefore, even if the Commission wishes to maintain some regulatory review of AT&T's affiliate transactions, AT&T should not be required to implement the proposed new rules.

Indeed, the Commission has just recently concluded a proceeding in which it found that AT&T's price cap system has operated extremely successfully under the Commission's current rules. The Commission found that AT&T's price cap system has produced enormous consumer benefits over the past four years, and has contributed to the explosion of interexchange competition that has occurred since the Bell System divestiture.[37] In light of these conclusions, and in light of the extremely healthy state of competition in the interexchange market, there is simply no basis for revising the rules to which AT&T is subject, which themselves are now unnecessary.

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[37] Price Cap Performance Review for AT&T, 8 FCC Rcd. at 5166-67.

CONCLUSION

For the reasons stated, the Commission should adopt the suggestion of Paragraph 101 of the NPRM and eliminate the application of affiliate transactions rules to AT&T.

Respectfully submitted,

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

By _____

Francine J. Berry
Robert J. McKee
Judy Sello

Room 3244J1
295 North Maple Avenue
Basking Ridge, NJ 07920

Marc E. Manly
Ashutosh A. Bhagwat

1722 Eye Street, N.W.
Washington, D.C. 20006

Its Attorneys

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